Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Calderon	Analyst:	Gail Hall	Bill Number:	SBX3 15
Related Bills:	See Legislative History	Telephone:	845-6111	Amended Date:	February 14, 2009
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT:	California Motion Picture Credit/New Employee Credit/FTB Report Credits Claimed On Web Site/No Additional Tax For Underpayment Of Installment Created By Credit Disallowance/Economic Nexus/Sales Of Other Than Tangibles/Define Sales/Single Sales Factor

SUMMARY

This bill would make the following changes:

Provision No. 1: Provide a $3,000 credit against tax for each increase in qualified full-time employee hired by a qualified employer, as defined, limited to a cumulative total of allowable credit of $400 million dollars.

Provision No. 2: Create a tax credit for the production of a qualified motion picture in California.

Provision No. 3: Allow specific entities to elect to utilize a sales only formula to apportion its income subject to franchise or income tax.

Provision No. 4: Provide a bright-line test for when an entity is doing business in California.

Provision No. 5: Clarify the definition for “what is a sale.”

Provision No. 6: Modify the rules for assigning certain receipts for inclusion in the sales factor.

PURPOSE OF THE BILL

It appears that the purpose of this bill is to increase economic productivity in California and encourage certain industries to invest in California.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately. The operative dates of these changes vary and will be addressed separately for each provision.

POSITION

Pending.

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP		
_______ SA	_______ O	_______ NAR	Selvi Stanislaus	02/27/09
_______ N	_______ OUA	____X___ PENDING		

ECONOMIC IMPACT – SUMMARY REVENUE TABLE

The Revenue Estimate for SBX3 15 Provision No. 1 New Jobs Tax Credit Effective for Tax Years BOA 1/1/2009 Assumed Enactment Date before 2/28/09			
($ In Millions)			
	2008/09	2009/10	2010/11
New Jobs Tax Credit	-$15	-$330	-$50

The Revenue Estimate for SBX3 15 Provisions No. 2, 3, 4, 5, and 6 Effective for Tax Years BOA 1/1/2011 Assumed Enactment Date before 2/28/09			
($ In Millions)			
	2010/11	2011/12	2012/13
Provision No. 2: Motion Picture Tax Credit	-$ 45	-$135	-$105
Provision No. 3: Single Sales Factor	-$250	-$750	-$800
Provision No. 4, 5, and 6: Nexus/Apportionment Provisions	+$10 to $25	+$30 to $70	+$30 to $70

PROVISION 1: NEW JOBS TAX CREDIT

EFFECTIVE/OPERATIVE DATE

As a tax levy, this provision would be immediately effective upon enactment and by its own terms, would be operative for taxable years beginning on or after January 1, 2009, and would be repealed on December 1 of the year after the year in which the allowable credit limit is reached.

ANALYSIS

FEDERAL/STATE LAW

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Under state law, for taxable years beginning on or after January 1, 2008, and before January 1, 2010, the total of all business credits otherwise allowable may not exceed 50% of the net tax of the taxpayer for that taxable year. Taxpayers with net business income of less than $500,000 are excluded from this limitation.

Under state law, if a taxpayer fails to pay the amount of tax shown due on a return by the original due date of the return, a penalty would be imposed in the amount of 5% of the unpaid tax plus an additional 0.5% of the unpaid tax for each month or part of a month it remains unpaid. The maximum penalty is 25% of the unpaid tax.

Additionally, if a taxpayer underpays an installment of estimate tax, a penalty is calculated on the unpaid amount from the due date of the estimated tax installment to the date payment is received, or to the due date of the return, whichever is earlier. The penalty is computed at the same rate as interest for the period of underpayment.

THIS PROVISION

This provision would, for taxable years beginning on or after January 1, 2009, provide a credit against tax for a qualified employer in the amount of $3,000 for each increase in a qualified full-time employee hired by a qualified employer in the taxable year, determined on an annual full-time equivalent basis. Any credits not used in the taxable year may be carried forward up to eight years. The credit would not be subject to the 50% limitation for business credits that exists for taxable years beginning on or after January 1, 2008, and before January 1, 2010.

This provision would provide definitions for the following terms:

- Acquired
- Qualified full-time employee
- Qualified employer
- Qualified wages
- Annual full-time equivalent

A qualified full-time employee is defined as:

- A qualified employee who was paid qualified wages by the qualified employer for services of not less than an average of 35 hours per week.
- A qualified employee who was a salaried employee and was paid compensation during the taxable year for full-time employment, within the meaning of provisions of the Labor Code.

A qualified employee would not include any of the following:

- Employees certified as a qualified employee in an enterprise zone,
- Employees certified as a qualified employee in a manufacturing enhancement area or a targeted tax area,
- Employees certified as a qualified disadvantaged individual or qualified displaced employee in a local agency military base recovery area, or
- Employees whose wages are included in calculating any other credit allowed.

The term annual full-time equivalent is further defined to mean either of the following:

- In the case of a full-time employee that is paid hourly, the total number of hours worked for the taxpayer by the employee may not exceed 2,000 hours divided by 2,000.
- In the case of salaried full-time employees, the total number of weeks worked for the taxpayer divided by 52.

The provisions would provide that the net increase in qualified employees would be determined on an annual full-time equivalent basis by comparing the number of full-time employees employed by the taxpayer in the current taxable year with the number of qualified full-time employees that were employed by the taxpayer in the preceding taxable year. For taxpayers who first commenced doing business in the state during the taxable year, the number of qualified full-time employees for the immediately preceding taxable year would be zero.

The provisions would specify that any deductions an employer is allowed for qualified wages would not be reduced by the amount of the credit. Taxpayers may only claim this credit on an original timely filed return received by Franchise Tax Board (FTB) on or before a cut-off date specified by FTB, which would be the last day of the calendar quarter within which FTB estimates it will have received timely filed original returns claiming the credit that cumulatively total $400 million for all taxable years. The date received on a return would be determined by FTB. Determinations made by FTB with respect to the cut-off date, the date a return is received, and whether a return has been timely filed may not be reviewed in any administrative or judicial proceeding.

Additionally, any disallowance of the credit due to the cumulative total of the credit being reached would be treated as a math error, and would not be subject to review in any administrative or judicial proceeding.

FTB would provide periodic notice on its website of the amount of the credit claimed on timely filed original returns and may prescribe rules, guidelines, or procedures necessary to carry out these provisions. Any rules, guidelines, or procedures established would be exempt from the Administrative Procedures Act.

This provision also would provide that a penalty for the underpayment of estimated tax or underpayment of tax would not be made if the underpayment was created or increased by the disallowance of the credit because of this limitation.

This provision would remain in effect only until December 1 of the calendar year after the year in which the cumulative credit limit has been reached and is repealed as of that date.

FISCAL IMPACT

Implementing the new job tax credit under this bill’s provisions would require FTB to revise tax return processing procedures, make system changes to collect data from the returns upfront, and monitor the allowance of the credit to reach the cap of $400 million. FTB estimates it would incur first year implementation costs of approximately $334,000 (3.0 PY) with ongoing annual costs of approximately $24,000 (4 PY).

ECONOMIC IMPACT

Tax Revenue Estimate

The Revenue Estimate for SBX3 15 Provision No. 1 New Jobs Tax Credit Effective for Tax Years BOA 1/1/2009 Assumed Enactment Date before 2/28/09			
($ In Millions)			
	2008/09	2009/10	2010/11
New Jobs Tax Credit	-$15	-$330	-$50

This analysis does not account for changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The revenue impact depends on the number of California taxpayers that employ individuals who work in California and the extent that such firms increase their employment over the base period.

The starting point for this estimate is data for the U.S. Bureau of Labor on gross job gains and gross job losses in California and on gross job gains and gross job losses by firm size. Gross job gains for California, per quarter from the third quarter of 1998 to the first quarter of 2008, have ranged from 1.25 million in the 3rd quarter of 1998 to just under 900,000 in the 1st quarter of 2008. Based on this information, and Department of Finance (DOF) projections on economic growth for 2009 and 2010, it is estimated that there will be 750,000 in gross job gains in 2009. The number of gross job gains in 2010 is projected to be 900,000.

Data from the Bureau of Labor Statistics on gross job gains by size of firm suggests that about 40% of gross job gains occur in firms with fewer than 20 employees. Multiplying the estimated 750,000 gross job gains in 2009 by 40% yields an estimated 300,000 new jobs for which this credit would be available. This number is reduced slightly to take into account employees for who an enterprise zone hiring credit is claimed.

The data on gross job gains considers full-time equivalents rather than full-time employees. It is estimated that about 20% of full-time employee equivalents are generated by part-time employees. Therefore, the application of the more stringent full-time employee requirement would reduce the number of qualified gross job gains to approximately 240,000 in 2009 (300,000 jobs X (100% - 20%) = 240,000 jobs). The number of qualified new full-time jobs is multiplied by the credit amount, $3,000, to generate the total amount of credit $720 million (240,000 qualified new jobs X $3,000 credit = $720 million). Based on experience with other credits, it is assumed that only 75% of these credits that were eligible to be claimed would be claimed on 2009 tax returns. Therefore, the total amount of credits claimed on 2009 tax returns is estimated at $540 million ($720 million in potential credits X 75% actually claimed = $540 million).

It is assumed that only 60% of this credit would be used on 2009 tax returns, and that 50% of the remainder would be used over 3 years. The estimated amount of credit used against tax for the 2009 tax year would be approximately $324 million. Because of the $400 million cap mechanism on the total amount of credit claimed, it is estimated that this credit would only be available for the 2009 tax year. The numbers in the table above have been converted to fiscal years.

PROVISION 2: MOTION PICTURE TAX CREDIT

EFFECTIVE/OPERATIVE DATE

As a tax levy, this provision would be effective immediately upon enactment and would be specifically operative as follows:

- Tax credits would be allowed for taxable years beginning on or after January 1, 2011, in which the California Film Commission (CFC) issues a credit certificate.
- Tax credits would be allocated by the CFC beginning on or after July 1, 2009, and before July 1, 2014.
- Tax credits would be for the applicable percentage of all qualified expenditures paid or incurred in all taxable years for the qualified motion picture.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

Current state and federal laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business (e.g., employee wages and benefits). When a taxpayer produces or creates a product (e.g., video, film, etc.), the taxpayer will generally incur a major portion of the expenses before the product begins to produce income. When this occurs, the taxpayer is usually required to capitalize those expenses and amortize—recover or deduct—them over the period that the product produces income using a specialized cost recovery method called the "income forecast" method. Amortized expenses include costs of researching, preparing, producing, recording, and other direct production costs. It also includes an allocation of indirect costs such as utilities, tools, clerical expenses, and equipment rental.

The federal American Jobs Creation Act (AJCA) of 2004 contains provisions that impact the income tax treatment of motion picture productions. Effective for productions commencing after October 22, 2004, and before January 1, 2010, provisions added by the AJCA permit owners of qualifying film and television productions to elect to deduct certain production expenditures in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances under the income forecast method discussed above. This provision only applies to qualified productions, the aggregate cost of which does not exceed $15 million. For this purpose, a qualified film or television production is defined as any production of a motion picture, miniseries, scripted, dramatic television episode, or movie of the week if at least 75% of the total compensation expended on the production is for services performed in the United States. For an episodic television series, only the first 44 episodes qualify under the provision. The AJCA modifies the income forecast method to include certain participations and residuals in the adjusted basis of the property. The AJCA also allows a deduction equal to a portion of the taxpayer’s qualified domestic production activities, including any disposition, lease, rental, or license of qualified film produced by the taxpayer. California has not conformed to the AJCA provisions.

Current state and federal laws do not provide any tax credits relating to production of commercials or motion pictures.

THIS PROVISION

This provision would apply to Personal Income Tax Law and Corporation Tax Law and create a franchise or income tax credit to a qualified taxpayer, as defined, for 20% of qualified expenditures, as defined, attributable to the production of a qualified motion picture, as defined, and 25% of qualified expenditures, as defined, attributable to the production of a qualified motion picture where the motion picture is a television series relocated to California or an independent film, as defined, in California that is allocated and certified by the CFC. Any credit unused in a taxable year because it is in excess of the taxpayer's tax liability could be carried over for six taxable years.

A qualified taxpayer may, in lieu of claiming the credit allowed by this provision, make an irrevocable election to apply the credit amount against qualified sales and use taxes imposed on the qualified taxpayer.

This provision provides that the aggregate amount of credits that may be allocated by the CFC in any fiscal year would be equal to the following:

- $100 million in credits for the 2009/10 fiscal year and each fiscal year thereafter, through and including the 2013/14 fiscal year.
- The unused allocation credit amount, if any, for the preceding fiscal year.
- The amount of previously allocated credit not certified.

For credits attributable to an independent film, the qualified taxpayer would be permitted to sell the credit to an unrelated party. The unrelated party is subject to the same requirements of this provision. The qualified taxpayer would be required to report to FTB prior to the sale of the credit all required information in the form and manner specified by FTB. Credits could not be sold to more than one taxpayer nor may the credit be resold by the purchaser to another party. In the event that both the taxpayer originally allocated a credit by the CFC and a taxpayer to whom the credit has been sold both claim the same amount of credit on their tax returns, FTB may disallow the credit of either taxpayer, as long as the statute of limitations upon assessment remains open. FTB is authorized to prescribe rules, standards, procedures, and the like to implement this aspect of the provisions. The Administrative Procedures Act requirements regarding regulations would not apply.

In accordance with rules and regulations required to be promulgated by the CFC, qualified taxpayers must comply with audit requirements prior to the issuance by CFC of the certified allocation amount. The credit would be disallowed if the taxpayer fails to provide the copyright registration number required by the CFC and until this requirement is met.

Annually, the CFC would be required to provide the FTB with a list of qualified taxpayers and the tax credit amounts allocated to each qualified taxpayer by the CFC. The FTB would be required to accept the tax credit amounts as reported on the CFC listing.

In addition, the Business, Transportation, and Housing Agency would be required to report to the Legislature on the economic impact of the Motion Picture Tax Credit, and may consult with FTB and other agencies before completing the report.

FISCAL IMPACT

The estimated cost to implement this provision would be approximately $40,000 for modification of the individual and corporate tax systems to accommodate the new credits and other automated and manual return processing functions. Such functions would include the development of a process to track sales and purchases of credits originally allocated to qualified taxpayers. Estimated annual costs to process returns claiming the credit would be approximately $96,000. It is assumed that FTB's activities to administer this provision would be limited to verifying that the taxpayer claiming the credit is in fact the qualified taxpayer allocated credits by the CFC or purchaser of such credits, and then making or denying the credit as applicable.

ECONOMIC IMPACT

Tax Revenue Estimate

Based on data and assumptions discussed below, this provision would result in the following revenue losses.

Estimated Revenue Impact of the Movie Credit Effective for Tax Years BOA 1/1/2011 Assumed Enactment Date before 2/28/09		
($ In Millions)		
2010/11	2011/12	2012/13
-$45	-$135	-$105

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The revenue impact of the credit is dependent on the amount of qualified wages and qualified tangible personal property purchased or leased, and the portion of allocated credit used to reduce tax liabilities.

Based on employment data for the film/video production industry in California and adjusting for tangible personal property, total credits for qualified wages and property are anticipated to exceed the combined annual credit cap of $100 million. Although the CFC can commence the allocation process on July 1, 2009, tax year 2011 is the first year taxpayers would be able to use generated credits to reduce their tax liabilities.

The following assumptions alter the allocation and use of the capped credits:

- The CFC will need time to establish an approval process, thus the commencement of credit allocation is slightly delayed;
- Projects will, on average, be completed over a three-year period; and lastly,
- Credits allocated for projects that are later abandoned would be reassigned by the CFC in later years.

Credits available for use for tax year 2011 include allocations made during fiscal year 2009/10, 2010/11, and 2011/12. The revenue impact for tax year 2011 is as follows:

<u>Credits Allocated during fiscal year 2009/10 and used in 2011</u>

For the first year, it is assumed that only $80 million ($100 million fiscal year cap x 80%) would be allocated. Assuming a two-year average production cycle, all credits allocated during fiscal year 2009/10 would be available for use to reduce tax year 2011 liabilities (includes films completed during 2009, 2010, and 2011). To reflect usage, as limited by actual tax liabilities, it is assumed that on average taxpayers will use 80% of available credits ($80 million x 80% = $65 million). Remaining, unused credits are assumed to reduce liabilities over the next three taxable years (2012 through 2014). Additionally, credit usage is reduced to $63 million for films that subsequent to the credit allocation become abandoned. The CFC would have to reallocate these credits in later years. In summary, total credits allocated during fiscal year 2009/10 and used to reduce tax year 2011 liabilities is estimated to total $63 million.

<u>Credits Allocated during fiscal year 2010/11 and used in 2011</u>

For the second year (fiscal year 2010/11), it is assumed that allocated credits total $120 million, including $20 million in credits unallocated during 2009/10 plus the annual allocation limit of $100 million for the new fiscal year. Assuming the same two-year average production cycle (with credits being allocated between July of 2010 and June of 2011), credits allocated and available for use is limited to films completed during 2010 and 2011. Based on the assumptions outlined above, total credits allocated during fiscal year 2010/11 and used to reduce tax year 2011 liabilities is estimate to total $78 million.

<u>Credits Allocated during fiscal year 2011/12 and used in 2011</u>

For the third year (fiscal year 2011/12), it is assumed that allocated credits total $100 million. This amount reflects the annual allocation limit of $100 million for the new fiscal year. Assuming the same two-year average production cycle, credits allocated and available for use is limited to films completed during 2011. Based on the assumptions outlined above, total credits allocated during fiscal year 2011/12 and used to reduce tax year 2011 liabilities is estimated to total $12 million.

In summary, tax year 2011 is the first year allocated credits can be used to reduce income tax liabilities. Credits that impact the 2011 tax year include credits allocated by the CFC during fiscal year 2009/10 through 2011/12. Of the $280 million credits allocated over three fiscal years, it is estimated that approximately $150 million ($63 million from 2009/10 + $78 million from 2010/11 + $12 million from 2011/12) in credits would be used to reduce tax year 2011 liabilities. The revenue loss in the chart reflects the usage pattern on a fiscal year basis.

PROVISION 3: ELECTION TO USE A SALES ONLY FORMULA

EFFECTIVE/OPERATIVE DATE

As a tax levy, this provision would be effective and operative immediately upon enactment; however, some provisions would be specifically operative for taxable years beginning on or after January 1, 2011.

ANALYSIS

FEDERAL/STATE LAW

The federal method of taxing corporations doing business within and without the United States is different from the California method for taxing corporations doing business within and without the state; therefore, federal law is inapplicable.

California has adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), with certain modifications, to determine how much of an apportioning taxpayer's total income, which is earned from activities both inside and outside of California, is attributed to California and subject to California franchise or income tax. UDITPA uses an apportionment formula to determine the amount of "business" income attributable to California[1].

The apportionment formula consists of property, payroll, and sales factors. Each of these factors is a fraction the numerator of which is the value of the item in California and the denominator of which is the value of the item everywhere. The property factor includes tangible property owned or rented during the taxable year; the payroll factor includes all forms of compensation paid to employees; and the sales factor generally includes all gross receipts from the sale of tangible and intangible property. For most taxpayers, the sales factor is double-weighted.

The calculation of this apportionment formula and California business income is illustrated below.

$$\frac{\boxed{\dfrac{\textbf{Average CA Property}}{\text{Average Total Property Everywhere}}} + \boxed{\dfrac{\textbf{CA Payroll}}{\text{Total Payroll Everywhere}}} + \left(2 \times \boxed{\dfrac{\textbf{CA Sales}}{\text{Total Sales Everywhere}}}\right)}{4} = \text{California Apportionment Percentage}$$

X Total Business Income
= California Business Income

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[1] "Business income attributable to California" is a taxpayer's "business income" multiplied by its California apportionment formula. Revenue and Taxation Code (R&TC) section 25120(a) defines "business income" as income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

For taxable years beginning on or after January 1, 1993, the apportionment formula for most taxpayers has been a three-factor apportionment formula consisting of property, payroll, and double-weighted sales (three-factor, double-weighted sales). An exception to this rule exists for taxpayers of an apportioning trade or business that derive more than 50% of its gross business receipts from conducting a “qualified business activity.” These taxpayers are required to use a three-factor, single-weighted sales, apportionment formula. For this purpose, a qualified business activity is defined as an agricultural, extractive, savings and loan, and banking or financial business activity. In addition, current law requires that once a determination has been made that the apportioning trade or business is involved in a qualified business activity, all members of the apportioning trade or business use the same weighting, regardless of whether the particular entity was involved in a qualified business activity.

State law permits a departure from the standard apportionment provisions only in limited and specific cases[2], and recognizes that the standard apportionment provisions are not appropriate when applied to certain industries and types of transactions, in which case special apportionment provisions exist for those situations[3].

<u>THIS PROVISION</u>

This provision would allow an apportioning trade or business to make an annual, irrevocable election to utilize a single factor, 100% sales, (single sales factor) apportionment formula instead of the three factor, double-weighted sales apportionment formula described in the FEDERAL/STATE LAW section. Qualified business activities (described above) would be specifically prohibited from electing a single sales factor apportionment formula.

The election would be on a timely filed original return in the manner and form prescribed by the FTB.

FISCAL IMPACT

This provision would not significantly impact the department’s costs.

ECONOMIC IMPACT

The revenue estimate and discussion for this provision is provided on the last page of this analysis.

PROVISION 4: BRIGHT-LINE TEST FOR WHEN AN ENTITY IS DOING BUSINESS IN CALIFORNIA

EFFECTIVE/OPERATIVE DATE

As a tax levy, this provision would be effective and operative immediately upon enactment; however, some provisions would be specifically operative for taxable years beginning on or after January 1, 2011.

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[2] R&TC section 25137.
[3] California Code of Regulations (CCR), title 18, section 25137.

ANALYSIS

FEDERAL LAW

A corporation is subject to federal income tax if it is formed in the United States or it conducts a trade or business in the United States.

STATE LAW

For a state (or other taxing jurisdiction) to impose a tax, the Due Process and Commerce Clauses of the U.S. Constitution require that the taxpayer have a certain minimum connection, or nexus, within the state. California utilizes the term “doing business” to establish liability for the corporate franchise tax. “Doing business” is defined in current state law as actively engaging in any transaction for the purpose of financial or pecuniary gain or profit.

The point at which sufficient nexus is reached has not been precisely defined, but a number of court cases have addressed the issue and have provided some parameters. For many years, the standard for establishing nexus was considered to be physical presence within the state. Recently, the trend in the courts, especially on the East Coast, appears to be a de-emphasis of the physical presence requirements in recognition of the changing business environment.[4]

THIS PROVISION

This provision would establish a bright-line test and provide that a taxpayer is doing business in California if any of the following conditions are satisfied:

1. The taxpayer is organized or commercially domiciled in this state.
2. Sales of the taxpayer in this state exceed the lesser of $500,000 or 25% of the taxpayer’s total sales. Sales of the taxpayer would include sales by an agent or independent contractor of the taxpayer.
3. The real and tangible personal property of the taxpayer in this state exceeds the lesser of $50,000 or 25% of the taxpayer’s total real and tangible personal property.
4. The amount paid in this state by the taxpayer for compensation exceeds the lesser of $50,000 or 25% of the total compensation paid by the taxpayer.

This provision requires the FTB to revise the amounts described in items 2, 3, and 4 above on an annual basis in a similar manner used to recompute the state income tax brackets.

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[4] Lanco Inc. v. Director, Division of Taxation, 908 A.2d 176 (N.J. 2006)
MBNA America Bank, N.A. v. Tax Commissioner of the State of West Virginia, 640 S.E.2d 226 (W.Va. 2006)
Capital One Bank v. Commissioner of Revenue (just decided January 8, 2009 in the Massachusetts Supreme Judicial Court)
Geoffrey Inc. v. Commissioner of Revenue (just decided January 8, 2009 in the Massachusetts Supreme Judicial Court)
MBNA America Bank N.A. et al. v. Dep't of Revenue (Indiana Tax Court October 20, 2008)
Bridges v. Geoffrey Inc., (Louisiana Court of Appeal, Feb. 8, 2008)
A & F Trademark, Inc. v. Tolson, 167 N.C. App. 150, 605 S.E. 2d 187 (N.C. Ct. App. 2004),
Geoffrey, Inc. v. Oklahoma Tax Commission, 132 P. 3d 632 (Okla. Ct. App. 2005)

This provision provides that the sales, property, and payroll of the taxpayer would include the taxpayer's pro rata or distributive share of pass-through entities. This provision defines "pass-through entities" as a partnership or an "S" corporation.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

The revenue estimate and discussion for this provision is provided on the last page of this analysis.

PROVISION 5: DEFINITION OF A SALE

EFFECTIVE/OPERATIVE DATE

As a tax levy, this provision would be effective immediately upon enactment and would be specifically operative for taxable years beginning on or after January 1, 2011.

ANALYSIS

FEDERAL/STATE LAW

The issues discussed in this provision are not applicable to federal law because the federal method of taxation is different from the California method.

As discussed above in PROVISION NO. 3 in the **FEDERAL/STATE LAW** section, the formula used by California to determine the amount of business income apportioned to the state consists of a property factor, payroll factor, and a sales factor. The sales factor is defined as a taxpayer's total California sales divided by a taxpayer's total sales everywhere.[5] Sales are defined as all gross receipts of the taxpayer except for certain nonbusiness income.[6] California statutory law does not provide a definition for gross receipts. A regulation provides rules for excluding certain receipts from the sales factor as related to treasury function activities.[7]

<u>THIS PROVISION</u>

This provision would define gross receipts as the gross amounts realized (the sum of money and the fair market value of other property or services received), but shall not include the following items:

- Repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, certificate of deposit, or similar marketable instrument.
- The principal amount received under a repurchase agreement or other transaction properly characterized as a loan.
- Proceeds from issuance of the taxpayer's own stock or from sale of treasury stock.

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[5] R&TC section 25134.
[6] R&TC section 25120(e).
[7] California Code of Regulations (CCR) section 25137(c)(1)(D).

- Damages and other amounts received as the result of litigation.
- Property acquired by an agent on behalf of another.
- Tax refunds and other tax benefit recoveries.
- Pension reversions.
- Contributions to capital (except for sales of securities by securities dealers).
- Income from discharge of indebtedness.
- Amounts realized from exchanges of inventory that are not recognized under the Internal Revenue Code.
- Amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer's unitary business and the gross receipts and overall net gains from the maturity, redemption, sale, exchange, or other disposition of those intangible assets. For purposes of this subparagraph, "treasury function" means the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the taxpayer's trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, and business acquisitions, and also includes the use of futures contracts and options contracts to hedge foreign currency fluctuations. A taxpayer principally engaged in the trade or business of purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function, such as a registered broker-dealer, is not performing a treasury function, for purposes of this subparagraph, with respect to income so produced.
- Amounts received from hedging transactions involving intangible assets. A "hedging transaction" means a transaction related to the taxpayer's trading function involving futures and options transactions for the purpose of hedging price risk of the products or commodities consumed, produced, or sold by the taxpayer.

In addition, this provision provides that an exclusion of an item from the definition of "gross receipts" shall not be determinative of its character as business or nonbusiness income, and the changes made by this provision are clarifying and nonsubstantive.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

The revenue estimate and discussion for this provision is provided on the last page of this analysis.

PROVISION 6: MODIFY THE RULES FOR ASSIGNING CERTAIN RECEIPTS

EFFECTIVE/OPERATIVE DATE

As a tax levy, this provision would be effective immediately upon enactment and would be specifically operative for taxable years beginning on or after January 1, 2011.

FEDERAL/STATE LAW

The issues discussed in this provision are not applicable to federal law because the federal method of taxation is different from the California method.

Current state law provides the following general rules utilized to determine California sales for the sales factor calculation:

- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser in this state, and the taxpayer (seller) is taxable in this state.
- Sales of tangible personal property are assigned to California if the product is delivered or shipped from California to a purchaser out of state, and the taxpayer (seller) is not taxable in the state of destination.
- Sales of tangible personal property to the U.S. Government are assigned to California if the goods were shipped from California.
- Sales from the performance of personal services are assigned to California if the services were performed in California. If personal services were performed in more than one state, then the receipts from the services would be assigned to California based on the ratio of time spent performing such services in the state to total time spent in performing such services everywhere.
- Sales from intangibles and all other services are assigned to California if the income producing activity that gave rise to the receipts is performed wholly within California. If the income producing activity is performed within and outside the state, then the sales from intangibles and all other services are assigned to California if the greater cost of performance of the income producing activity is performed in this state.
- Sales from the sale, rental, lease, or licensing of real property and the receipts derived from the rental, lease, or licensing of tangible personal property are assigned to California if the property is located in California.

THIS PROVISION

This provision would modify the provisions that provide the rules for assigning sales from tangible personal property (R&TC section 25135) and the rules for assigning sales from other than tangible personal property (R&TC section 25136).

Sales of Tangible Personal Property

This provision would modify the following rules for assigning sales from tangible personal property to the sales factor by adding an additional test to the rules.

- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser in this state, and the taxpayer (seller) or any member of the combined reporting group is taxable in this state.
- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser out of state, and the taxpayer (seller) or any member of the combined reporting group is not taxable in the state of destination. In addition, this provision would provide that FTB may prescribe legislative rules and regulations to carryout the purposes of this provision.

Sales of Other Than Tangible Personal Property

This provision would provide the following rules for assigning sales of other than tangible personal property:

- Sales from services are in this state to the extent the purchaser of the service received the benefit of the service in this state.
- Sales from intangible property are in this state to the extent the property is used in this state. In the case of marketable securities, sales are in this state if the customer is in this state.
- Sales from the sale, lease, rental, or licensing of real property are in this state if the real property is located in this state.
- Sales from the rental, lease, or licensing of tangible personal property are in this state if the property is located in this state.

In addition, this provision would provide that FTB may prescribe legislative rules and regulations to carryout the purposes of this provision.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

The Revenue Estimate for SBX3 15 Provisions No. 3, 4, 5, and 6 Effective for Tax Years BOA 1/1/2011 Assumed Enactment Date before 2/28/09			
($ In Millions)			
	2010/11	2011/12	2012/13
Provision No. 3: Single Sales Factor	-$250	-$750	-$800
Provision No. 4, 5, and 6: Nexus/Apportionment Provisions	+$10 to $25	+$30 to $70	+$30 to $70

Revenue Discussion

The impact of Provisions No. 3, 4, 5, and 6 was estimated using our corporate microsimulation model. Taxes owed by each eligible corporation in our sample were recalculated using the single sales factor method. The total tax reduction for corporations benefiting from the single sales factor method was tabulated. This calculation was undertaken for three different tax years. These results were averaged and the average was grown to reflect projected growth in corporate tax liabilities. The tax year projections were converted to fiscal years.

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